Supreme Court, U.S.
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No. ____

IN THE
Supreme Court of the United States
OCTOBER TERM, 1993

MYRNA RODRIGUEZ, JUAN E. LUGO, *et al.*,
Petitioners,

v.

SECRETARY OF THE TREASURY OF THE COMMONWEALTH OF PUERTO RICO, *et al.*,
Respondent.

Petition for Writ of Certiorari to the Supreme Court of Puerto Rico

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PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED

Whether federal law granting the cost-of-living allowance ("COLA") to federal civilian employees in Puerto Rico and exempting the COLA from federal income tax pre-empts the Commonwealth of Puerto Rico from imposing its own similar income tax on the COLA.

Whether the COLA is a noncompensatory allowance for which the United States has not given its consent to taxation by Puerto Rico pursuant to the Public Salary Tax Act, 4 U.S.C. § 111.

PARTIES BELOW *

Plaintiffs-Appellants:

> Myrna Rodriguez, Juan E. Lugo, Hector Arana, Juan N. Sanchez José Rolden, José Rodriguez, Jr., Elba G. De Picon, Zayda Hernandez, Floyd Olson, Shirley J. Suarez, Reinaldo Garcia-Cruz, Marshall D. Burgess, Ruben D. Vazquez, Harold E. Hopkins, Jr., Adolfo Mariani, José Ramos-Ortiz, Santos Mercado, Eugene Parker, and Carmen R. Alfonso-Sanchez, for themselves and on behalf of all others similarly situated, and COLA Defense Committee of Puerto Rico, Inc.

The plaintiff class certified by the Superior Court of Puerto Rico is described as follows:

> "All persons employed within the Commonweaith of Puerto Rico at any time on or after January 10, 1979, by the United States or any agency, establishment, or instrumentality thereof, or a corporation owned by the United States including but not limited to the United States Postal Service, who are or were entitled to receive a cost-of-living allowance, or a like payment as part of basic pay, by or in accordance with 5 U.S.C. section 5941.201-.213 (sic), and/or Executive Order 10,000, as amended, or pursuant to another statute, regulation, administrative practice or contract".

Defendant-Appellee:

> Secretary of the Treasury of the Commonwealth of Puerto Rico.

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* Pursuant to Rule 29.1, the named corporate petitioner states that it does not have any parent or subsidiary companies. The non-profit COLA Defense Committee of Puerto Rico, Inc., was formed pursuant to the order of the U.S. Claims Court in *Karamatsu v. United States*, No. 224-85C (Cl. Ct. Dec. 19, 1985).

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OPINIONS BELOW

The opinion of the Supreme Court of Puerto Rico is reported as *Rodriguez v. Secretario de Hacienda*, 94 JTS 20 (1994). The opinion of the Superior Court, San Juan Part (App. B), has not been reported in any official or unofficial reports. The Appendix sets forth certified translations of these opinions prepared by the court interpreter for the U.S. District Court for the District of Puerto Rico.

JURISDICTION

The judgment of the Supreme Court of Puerto Rico was entered on March 1, 1994 (App. 1a, 49a). This Court has jurisdiction under 28 U.S.C. § 1258.

STATUTES AND REGULATIONS INVOLVED

U.S. CONST. art. VI, cl. 2 (App. 50a).

4 U.S.C. § 111 (1988) (App. 50a).

5 U.S.C. § 5941 (1988) (App. 50a).

26 U.S.C. § 912(2) (1988) (App. 51a).

P.R. Laws Ann. tit. 13, § 3022(a) (1954) (App. 51a).

STATEMENT OF THE CASE

A. Nature of the Case

This case concerns the imposition of Puerto Rico's income tax on the federal cost-of-living allowance ("COLA") received by nearly 10,000 federal civilian employees who work in Puerto Rico. Petitioners contend that federal law creating the COLA program and exempting it from federal income tax bars the imposition of Puerto Rico's unique federal-style income tax on this noncompensatory allowance. Subjecting the COLA to Puerto Rico's income tax causes at lease the same diminution in the utility of the COLA as Congress intended to prevent by exempting it from federal income tax.

The federal questions sought to be reviewed were raised in the plaintiffs' initial class-action tax refund complaint filed in this case, which expressly asserted that federal law bars the imposition of Puerto Rico income tax on the COLA on the following grounds: (1) that the Secretary's taxation of the COLA unconstitutionally interferes with the purpose of the COLA program in violation of the Supremacy Clause (Complaint ¶ 4.1.4); (2) that the COLA is not "pay or compensation" as defined in the Public Salary Tax Act, 4 U.S.C. § 111, and the United States has not consented to its taxation by Puerto Rico (Complaint ¶ 4.1.5); and (3) that the Secretary's taxation of the COLA is discriminatory against members of the plaintiff class, in violation of 4 U.S.C. § 111 (Complaint ¶ 4.1.6).

These same questions of federal law were raised in the parties' cross-motions for summary judgment. In its opinion granting summary judgment in favor of the Secretary, the Superior Court set forth these federal law questions as the issues to be decided (App. 31a), holding that: (1) it need not apply the Supremacy Clause, because no specific provision of federal law forbids Puerto Rico's taxation of the COLA, expressly or otherwise (App. 39a); (2) as an addition to basic pay, the COLA constitutes "compensation" subject to taxation by Puerto Rico under 4 U.S.C. § 111 (App. 40a); and (3) that no question of fact precluded summary judgment on the issue of whether any exemptions recognized by Puerto Rico for quarters and subsistence allowances received by members of the Puerto Rico National Guard constituted discriminatory taxation of federal civilian employees' COLA (App. 45a).

These federal questions were again raised as specifications of error on appeal to the Supreme Court of Puerto Rico (App. 2a, n.3) and affirmed in all respects (App. 9a). In the majority opinion, the Supreme Court of Puerto Rico held that (1) the federal statute granting the COLA is silent on state or territorial taxation (App. 7a); whereas (2) the Public Salary Tax Act authorizes Puerto Rico's taxation of these allowances as "compensation additional to the basic wage" (App. 5a); and (3) the federal employees failed to prove that taxation of the COLA was discriminatory as to similarly situated persons (App. 5a).

Petitioners pray that a writ of certiorari be issued to review the judgment of the Supreme Court of Puerto Rico on these important questions of federal law which affect a large part of the federal workforce in Puerto Rico.

B. Statement of Facts

Pursuant to federal law, federal employees in Puerto Rico receive an allowance based on "living costs sub-

stantially higher than in the District of Columbia." 5 U.S.C. § 5941(a)(1) (App. 50a). This cost-of-living allowance, or "COLA", is computed by the Office of Personnel Management according to detailed surveys and economic analyses measuring differences in living costs between the Washington, D.C., area and the specific areas in which federal employees are eligible to receive the COLA. *See, e.g.,* 58 Fed. Reg. 45,556-45,651 (1993).

Based on analyses of these elaborate cost-of-living surveys, the Office of Personnel Management establishes COLA rates which are expressed as a percentage of base pay. 59 Fed. Reg. 13,844, 13,850 (1994). The Office of Personnel Management does not take income taxes into account in setting COLA rates. 59 Fed. Reg. 13,844, 13,845. At all times pertinent to this case, the COLA received by federal employees in Puerto Rico has been equal to ten percent (10%) of the employees' base pay.

The COLA is excluded from gross income and exempt from federal income taxes under 26 U.S.C. § 912(2) (App. 51a). The legislative history of the COLA tax exemption clearly indicates that Congress intended the COLA to better enable federal employees to carry out their official assignments, and to be "noncompensatory in character" as distinguished from other types of allowances or recruitment incentives. Rev. Rul. 59-407, 1959-2 C.B. 19, 20.

Despite the non-compensatory character of the COLA, the Secretary of the Treasury of the Commonwealth of Puerto Rico (hereinafter, the "Secretary") has taken the position that the COLA is subject to Puerto Rico's income tax. The Secretary's position is based solely on Puerto Rico's general income tax statute defining "gross income," and the absence of any express exclusion or exemption for the federal COLA. App. 14a, 33a; P.R. Laws Ann. tit. 13, § 3022(a) (App. 51a).

The Puerto Rico income tax system is similar to the federal income tax system, but unique among the other States, territories and possessions of the United States. Puerto Rico's income tax rates have generally been equal to or higher than federal income tax rates. For example, throughout the period 1979-1987, the marginal tax rate on individual taxable net income above $22,000 (married filing jointly) *exceeded forty percent (40%)*. P.R. Laws Ann. tit. 13, § 3011. Similar to the 1986 changes in the federal income tax rate structure, Puerto Rico's 1987 tax reform act generally lowered individual income tax rates and reduced the number of brackets. The current individual rates are 25% for taxable net income above $15,000, and 33% above $30,000. *Id.*

The interplay between Puerto Rican and federal income taxes also demonstrates the unique national character of Puerto Rico's income tax. Among bona fide Puerto Rico residents, only federal employees are subject to both federal and Puerto Rico income tax on their employment earnings in Puerto Rico. 26 U.S.C. § 933(1). To prevent double taxation, federal employees receive a credit against their federal tax liability, in the same manner as credits for taxes paid to a foreign country. 26 U.S.C. § 901. However, since the COLA is not subject to federal income tax, federal employees' payments of Puerto Rico income tax on the COLA may not be credited against federal income tax liability. 26 U.S.C. § 904.

No other COLA area has such a tax system. The Virgin Islands' income tax system mirrors the federal income tax, and the COLA is thus exempt from taxation according to federal law. *See* 48 U.S.C. § 1397. The same is essentially true for Guam. *See* 48 U.S.C. § 1421i. Alaska does not currently levy a state income tax on its residents. Among the COLA areas, Hawaii is the only other jurisdiction that imposes its income tax on the COLA. Haw. Rev. Stat. § 235-7(b). However, Hawaii's income tax rates are only a fraction of Puerto Rico's,

Haw. Rev. Stat. § 235-51, and the propriety of Hawaii's taxation of the COLA has never been litigated.

Thus, Puerto Rico's tax system has the character of a national income tax, and is essentially equivalent to the federal income tax from which Congress has expressly exempted the COLA. By diminishing the COLA from 25-40% for federal employees with only modest income, Puerto Rico's income tax has nullified the effectiveness of the COLA program in precisely the same manner (and to an even greater extent) as Congress sought to prevent when it exempted the COLA from federal income taxes.

C. Course of Proceedings

The long and tortuous proceedings in this case began in April of 1985, when the petitioners' counsel of record filed a claim with the Secretary on behalf of all federal employees in Puerto Rico seeking refunds of Puerto Rico income taxes paid on the COLA. In subsequent discussions, the treasury department maintained that the COLA was taxable, but the Secretary declined to issue a formal denial of the claim, a prerequisite for litigating tax refund claims in the courts of Puerto Rico. P.R. Laws Ann. tit. 13, § 3323.

Because the Secretary's inaction barred them from proceeding in the Commonwealth courts, and in view of the strong federal interests involved, the federal employees in 1987 filed a class action complaint in the U.S. District Court for the District of Puerto Rico. The district court dismissed the case for lack of subject matter jurisdiction under the Butler Act, 48 U.S.C. § 872. *Parker v. Agosto-Alicea*, Civ. No. 87-0386 (PG) (D. Puerto Rico) (Opinion and Order Feb. 4, 1988).

It was only after oral argument on appeal, when the panel pressed the Secretary's counsel on the question, that the Secretary formally issued a denial of the COLA tax refund claim pursuant to Puerto Rico law in his letter

dated May 10, 1989. *Parker v. Agosto-Alicea,* 878 F.2d 557, 559 (1st Cir. 1989). Since the federal employees were then able to pursue their remedies in the Commonwealth courts, the First Circuit affirmed dismissal for lack of jurisdiction. *Id.* at 560.

Following receipt of the Secretary's refund claim denial, the federal employees timely filed their class-action income tax refund complaint in this case in the Superior Court, San Juan Part, on June 9, 1989, pursuant to P.R. Laws Ann. tit. 13, § 3323. As a protective measure, the federal employees also filed an action seeking judicial review under the recently enacted Puerto Rico Administrative Procedure Act. *Lugo v. Secretary of the Treasury*, No. KAC89-0931 (906) (Superior Ct., San Juan Part).

Before proceedings got underway in either case, however, the Superior Court, *sua sponte*, dismissed this case in favor of the APA review procedure in the *Lugo* case on August 9, 1989. The federal employees appealed to the Supreme Court of Puerto Rico, while the Superior Court stayed proceedings in this case pending resolution of the fundamental question of the proper judicial procedure for income tax refund claims. Finally, more than two years after the complaint was filed in this case, the Puerto Rico Supreme Court reversed the lower court and remanded this case for further proceedings in the Superior Court. *Rodriguez v. Secretary of the Treasury*, RE89-501 (P.R. Supreme Court, June 13, 1991).

Following remand, on September 18, 1991, the Superior Court certified this case as a class action under Rule 20.2(a) and (b) of the Puerto Rico Rules of Civil Procedure, defining the plaintiff class as all federal employees who have received a COLA in Puerto Rico since 1979 (App. 48a). The court also required the plaintiffs to provide notice of the pendency of the class action by publication, and to send personal notice concerning the case to 28,000 past and present federal employees with

Puerto Rico addresses contained in plaintiffs' counsel's computer files from records created in COLA litigation against the United States, all at a cost to the plaintiffs in excess of $11,000.

The plaintiffs in September, 1991, propounded written discovery requests to the Secretary directed primarily at the question of whether the Secretary allowed exemptions of other similar types of allowances for non-federal employees or otherwise discriminated against federal employees in administering Puerto Rico's income tax system. However, with one minor exception, the Secretary failed to answer this discovery, and despite repeated motions by the plaintiffs, the Superior Court declined to compel any responses or deem any matters admitted.

The plaintiffs filed an amended complaint with leave of the court on January 22, 1992. On June 16, 1992, the Secretary filed a pleading styled as an answer to the amended compalint and an amended motion for summary judgment. The motion was supported by an affidavit from David Carrion Baralt averring that he was unaware of any treasury department ruling exempting certain national guard allowances from Puerto Rico income taxes.

When the plaintiffs sought to depose Mr. Carrion-Baralt, the court in its order dated August 19, 1992, canceled the deposition until after it ruled on the summary judgment motion. Thereafter, the federal employees filed their opposition to the Secretary's motion on September 11, 1992, along with a cross-motion for summary judgment on their pre-emption and Public Salary Tax Act claims.

The Superior Court granted the Secretary's motion for summary judgment in all respects on December 17, 1992 (App. 48a). Having prevented the federal employees from deposing the Secretary's only affiant (the only evidence submitted in support of his summary judgment motion), and having declined to require the Secretary to

respond to discovery requests submitted more than a year earlier, the court had no trouble finding an absence of factual issues to preclude summary judgment (App. 43a-47a).

Thus, after almost seven years, and prosecution of appeals to the both First Circuit and the Puerto Rico Supreme Court in order to obtain access to *de novo* review in the Puerto Rico courts, the federal employees' claims were dismissed before trial and without the benefit of discovery. The Supreme Court of Puerto Rico affirmed the Superior Court in all respects in its opinion and judgment entered March 1, 1994 (App. 1a).

ARGUMENT

I. PUERTO RICO'S TAXATION OF THE COST-OF-LIVING ALLOWANCE IS PRE-EMPTED BY FEDERAL LAW BECAUSE IT STANDS AS AN OBSTACLE TO CONGRESS' PURPOSE IN GRANTING THE COLA.

In granting the federal employees an allowance based on the higher cost of living in COLA areas pursuant to 5 U.S.C. § 5941(a)(1), and exempting it from federal income tax pursuant to 26 U.S.C. § 912(2), Congress expressed a clear intent that the COLA not be subjected to diminution by income taxation. Congress intended the allowance for official purposes, in light of higher living costs in the territories, and not as a recruitment incentive or compensation for hostile environmental conditions. As Congress recognized, subjecting the COLA to income taxation either reduces the effectiveness of the COLA to meet official requirements, or necessitates an addition to the COLA to offset the tax, both of which alternatives Congress has rejected.

Imposition of Puerto Rico's income tax on the COLA, at rates exceeding the federal income tax, effectively reduces the COLA in the same manner as Congress sought to prevent by exempting it from federal income taxes,

and stands as a direct obstacle to the full accomplishment of Congress' purpose in granting the COLA. Puerto Rico's taxation of the COLA is therefore pre-empted by federal law. Allowing the Puerto Rico courts' validation of this tax to stand in this case will do violence to Congress' intent, and harm to important federal interests in Puerto Rico.

While acknowledging the unique status of the Commonwealth of Puerto Rico, this Court has held that the federal pre-emption analysis for Puerto Rico is the same as for States under the Supremacy Clause, U.S. Const. Art. VI, cl. 2. *Puerto Rico Consumer Affairs Dept. v. Isla Petroleum Corp.*, 485 U.S. 495, 499 (1988).

The accepted tests for federal-preemption are set out in *Fidelity Federal Savings & Loan Assn. v. de la Cuesta*, 458 U.S. 141 (1982) (federal regulation authorizing due-on-sale clause in federal home loan documents preempts California law). Preemption requires examination of Congressional intent, and may be either express or implied. *Id.* at 152-53. In the absence of explicit language, Congress' intent to pre-empt state law may be inferred when Congress has created a federal regulatory scheme so pervasive as to leave no room for the states to supplement it. *Id.* at 153.

"Even when Congress has not completely displaced state regulation in a specific area, state law is nullified to the extent it actually conflicts with federal law." *Fidelity Federal*, 458 U.S. at 153. As in this case, "[s]uch a conflict arises . . . when state law '*stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress*[.]' " *Id.* at 153, *quoting Hines v. Davidowitz*, 312 U.S. 52, 67 (1941) (emphasis added).

In connection with the latter principle, the *Fidelity Federal* Court also observed that state law deserves no particular deference just because it is an area of "special concern" to the states. *Fidelity Federal*, 458 U.S. at 153

(real property law). This axiom applies equally in this case with regard to Puerto Rico's taxation of the COLA. Petitioners here do not seek to prevent Puerto Rico from collecting its income tax on their base pay and other forms of taxable compensation, nor to avoid paying their fair share of taxes to support the Commonwealth. They seek only to free their 10% COLA from taxation by Puerto Rico, as Congress intended. Any marginal fiscal impact on Puerto Rico is not material to the pre-emption analysis.

Finally, some recent resistance notwithstanding, this Court has long recognized the importance of legislative history in gleaning Congress' intent. *Wisconsin Public Intervenor v. Mortier*, 111 S. Ct. 2476, 2484 n.4 (1991).

The legislative history of the federal tax exemption for the COLA clearly sets forth Congress' purposes and objectives with respect to the COLA. As stated in S. Rep. No. 627, 78th Cong., 1st Sess. 24 (1943), which accompanied the enactment of Section 116(j) of the 1939 Internal Revenue Code, the predecessor of 26 U.S.C. § 912(2):

> [T]he income tax thus nullifies in large measure the efficacy of the allowances to meet official expenses incurred by personnel on foreign assignment, and granted in order to meet official requirements.
>
> * * * *
>
> Payment of allowances to meet extra costs of living at individual posts is indistinguishable from the payment of allowances to defray the expenses of operation of the establishment[.]
>
> * * * *
>
> [A]s the allowances are to meet official needs as distinguished from personal requirements, the exclusion of such allowances from tax consideration for this class of personnel is in the public interest.

This same language from the legislative history has been quoted extensively by the federal courts, and uni-

versally accepted as authority for Congress' purpose in establishing a tax-free COLA for federal employees outside the continental United States. *See Sjoroos v. Commissioner*, 81 T.C. 971, 973 n.6 (1983); *Grauvogel v. Commissioner*, 768 F.2d 1087, 1089 n.3 (9th Cir. 1985); Rev. Rul. 59-407, 1959-2 C.B. 19, 20, § 4.02. As restated by the Ninth Circuit Court of Appeals:

> The legislative history of section 912(2) indicates a legislative purpose to offset rising taxes and living costs of civilian employees overseas without increasing their COLA [citations and footnote omitted]. This decision implements broader congressional policy on administration of federal government activity outside the continental United States.

Grauvogel v. Commissioner, 768 F.2d 1087, 1089 (sustaining the COLA tax exemption against an equal protection challenge by an Alaska state employee).

The same legislative purpose was observed in another equal protection challenge to the COLA tax exemption. In *Sjoroos v. Commissioner of Internal Revenue*, 81 T.C. 971 (1983), the Tax Court referred extensively to the legislative history of the exemption granted by Section 912(2) of the Internal Revenue Code:

> The legislative classification made by the section thus reflects a policy decision by Congress as to how Federal employees should be recompensed for the added living costs they incurred while assigned to certain locations, i.e. by exemption of the cost-of-living allowances rather than by an increase in the amounts thereof.

Sjoroos, 81 T.C. at 974-75. Thus, by exempting the COLA from federal income tax, Congress clearly intended to avoid nullifying the efficacy of the COLA by taxation, while also avoiding increasing the COLA to offset any taxes imposed on it.

It cannot reasonably be argued that Puerto Rico's taxation of the COLA, at rates which cause a greater reduc-

tion than the federal income tax, does not present a grave obstacle to the accomplishment and execution of Congress' full purposes and objectives in granting the COLA. It should be noted that the Puerto Rico legislature has not specifically imposed its income tax on the COLA; rather, Puerto Rico's taxation of the COLA results solely from the Secretary's interpretation that COLA is included within the general definition of gross income.

The Puerto Rico courts gave short shrift to this implied pre-emption analysis, relying primarily on the absence of explicit pre-emption language in Congressional legislation (App. 7a, 26a, and 39a). Their pre-emption analyses conclude in essence that if Congress intended to pre-empt local taxation of the COLA, it would have said so. However, in the pre-emption context, "[t]his Court generally is reluctant to draw inferences from Congress' failure to act." *Schneidewind v. ANR Pipeline Co.*, 485 U.S. 293, 306 (1988). The Puerto Rico courts have ignored the crux of the implied pre-emption analyses, that Puerto Rico's taxation of the COLA frustrates Congress' purposes in providing a COLA free from diminution by federal or equivalent Puerto Rico income taxes.

II. THE UNITED STATES HAS NOT AUTHORIZED PUERTO RICO'S TAXATION OF THE NONCOMPENSATORY COST-OF-LIVING ALLOWANCE.

The Public Salary Tax Act of 1939 provides the United States' consent to non-discriminatory taxation by duly constituted taxing authorities of "pay or compensation for personal service as an officer or employee of the United States[.]" 4 U.S.C. § 111 (App. 50a). In all essential respects, this statute embodies the judicially developed doctrine of intergovernmental tax immunity. *Davis v. Michigan Dept. of Treasury*, 489 U.S. 803, 812-14 (1989).

Substantial portions of the Puerto Rico courts' opinions in this case are devoted to explaining why no genuine

issues of fact precluded summary judgment on this question, especially with respect to possible *preferential treatment* for certain allowances received by members of the Puerto Rico national guard. However, the plaintiffs in this case have been prevented from discovering evidence of the Puerto Rico treasury department's administrative practices which would constitute discriminatory taxation of the COLA. In view of the constraints placed upon them at the trial court level, the federal employees are unable at this stage of the proceedings to base their challenge to Puerto Rico's taxation of the COLA on impermissible discrimination under 4 U.S.C. § 111.

The petitioners here contend that the COLA, by its nature and according to federal law, is non-compensatory in character. Accordingly, Congress has not expressly authorized Puerto Rico's taxation of the COLA under 4 U.S.C. § 111. Certainly, the Public Salary Tax Act does not waive Congress' power to pre-empt Puerto Rico's taxation of the COLA.

Determination of the character of the COLA is a question of federal law under the applicable federal statutes. *See, e.g., U.S. v. Onslow County Board of Education*, 728 F.2d 628, 636 (4th Cir. 1984), *citing California v. Buzard*, 382 U.S. 386, 393 (1966) (State labels for forms of taxes are not conclusive).

The federal Internal Revenue Service has specifically analyzed this question in order to clarify the status of the COLA and other types of allowances granted to federal employees in both foreign and non-foreign assignments. Based on the legislative history of the federal tax exemption for the COLA, the Internal Revenue Service has characterized the COLA as follows:

> A cost-of-living allowance, within the meaning of section 912(1), is an allowance based on living costs substantially higher than the cost-of-living in the District of Columbia and granted to enable employees to render more complete and efficient service in carry-

> ing out their official assignments. Such allowances are *noncompensatory in character.*

Rev. Rul. 59-407, 1959-2 C.B. 19, 20, § 4.02 (emphasis added), *citing* S. Rep. No. 627, 78th Cong., 1944 C.B. 973, 992. In its ruling, the IRS carefully distinguished the COLA from other types of allowances and differentials granted as recruitment incentives by reason of environment or location of the duty, and allowances "considered as part of the compensation in fixing salary." *Id.*, § 405. Thus, for decades the federal agency charged with interpreting and administering Congress' purposes in this area of the law has held that the COLA cannot properly be described as "compensation."

Unlike basic pay and other forms of "compensation," the COLA is subject to increase or decrease by reason of measured differences in the costs of living between the COLA areas and Washington, D.C. Moreover, it is also not included in basic pay for purposes of computing federal employees' retirement benefits. 5 U.S.C. § 8331(3).

In *Anderson v. United States*, 16 Cl. Ct. 530 (1989), *aff'd* 929 F.2d 648 (Fed. Cir. 1991), the federal courts recently construed the character of certain payments for living quarters and temporary lodging received by federal civilian employees on overseas assignments for the purpose of determining whether that allowance constituted "wages" subject to FICA withholding. These allowances, granted pursuant to the Overseas Differentials and Allowances Act ("ODAA"), 5 U.S.C. § 5923, are exempted from federal income taxation under 26 U.S.C. § 912, the same code section that exempts the COLA. However, Congress has not expressly applied that exclusion to FICA withholding.

The Claims Court held that such allowances were in the nature of reimbursements for federal employees' additional expenses, and that Congress did not intend them to be considered as "compensation" for tax purposes.

Anderson v. U.S., 16 Cl. Ct. 530, 537 (1989). In affirming, the Federal Circuit concluded:

> In contrast, ODAA payments have never been within the definition of "gross income." ODAA payments have always been specifically excluded from being treated as income under section 61(a). . . . [I]t follows that ODAA payments cannot be treated as "wages" under FICA if they are not first made "income."

Anderson, 929 F.2d at 654. Similarly, because COLA payments are excluded from gross income for taxation purposes as a matter of federal law, they cannot be considered "pay or compensation" under 4 U.S.C. § 111.

In view of *Anderson*, the holding of the court in *Romero v. Brady*, 764 F. Supp. 227 (D. Puerto Rico 1991), that the COLA is subject to income tax withholding under federal law, is clearly erroneous. The *Romero* case, upon which the Puerto Rico courts relied (see App. 7a, 21a), is currently on appeal to the Federal Circuit *sub nom Romero v. United States*, No. 91-1440.

Considering Congress' purposes in granting the COLA, and its intent that the COLA be noncompensatory in character, the Public Salary Tax Act does not provide Congress' consent or authorization for Puerto Rico to tax the COLA.

CONCLUSION

Puerto Rico's taxation of the COLA clearly contravenes Congress' intent with respect to the noncompensatory character of the COLA, and impermissibly interferes with accomplishment of Congress' purpose in granting the COLA. This interference with the right to receive a COLA free from diminution by taxation affects federal law enforcement personnel, engineers, air traffic controllers, mail carriers, social security administration clerks, and thousands of other civilian federal employees who provide essential federal services to the Commonwealth of Puerto Rico. By taxing the COLA, the Secretary has

disregarded all notions of comity with respect to Puerto Rico's federal relations. The Secretary should not be allowed to balance Puerto Rico's budget on the backs of federal employees.

The courts of Puerto Rico have misunderstood their role in passing on the important questions of federal law in this case. The Supreme Court of Puerto Rico has held that it cannot invalidate Puerto Rico's tax "by judicial fiat" (App. 9a). The Puerto Rico courts have jealously guarded Puerto Rico's power to tax, a power which they have announced that they are unwilling to surrender easily (App. 9a, 27a, 32a). However, as this Court has held, " '[t]he relative importance to the State of its own law is not material when there is a conflict with a valid federal law, for the Framers of the Constitution provided that federal law must prevail.' " *Fidelity Federal*, 458 U.S. at 153, *quoting Free v. Bland*, 369 U.S. 663, 666 (1962).

For all these reasons, this Court should grant the federal employees' petition, and on review, invalidate the Secretary's taxation of the COLA.

Respectfully submitted,

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